

ACTA ECONOMICA

Volume XV, No. 27 / December 2017

ISSN 1512-858X, e-ISSN 2232-738X

## PRELIMINARY COMMUNICATION

.....

UDC: 339.922:338.22(4-672EU)

DOI: 10.7251/ACE1727119M

COBISS.RS-ID 7737880

*Lidija Lj. Madžar<sup>1</sup>***Economic Policy Challenges of Small European Countries****Изазови економске политике у малим европским земљама****Summary**

*The aim of this paper is to study the pace and role of small states in international economic relations. The main characteristics of small states are a high degree of economic openness, export concentration and high dependence on strategic imports. In addition, their significant features are also indivisibility of overhead costs and diseconomies of scale. There is no single definition of small states since the size is a relative term. In addition to the size of population, sometimes other indicators are used as size criteria such as territory size or gross domestic product. This paper emphasizes the endogenous and macroeconomic characteristics of small states in detail and some small countries' problems that can be challenging in developing their economies. Furthermore, the concepts of small states' economic vulnerability and resilience are covered. This paper pays special attention to arguments in favor of regional cooperation among small countries. The final part of the paper is dedicated to the similarities, and also economic differences among the small European states. It also highlights the benefits of small states' membership into the European Union. Numerous economic benefits for small countries arise from the process of regional integration, especially with regard to strengthening economic resilience, foreign trade, strengthening their bargaining power, joint management of regional public goods, receiving technical assistance and geopolitical aspect.*

**Key words:** *economic vulnerability, economic resilience, diseconomies of scale, small domestic market, external shocks, regional cooperation, the European Union*

<sup>1</sup> Novi Sad Business School, Higher Education Institution for Applied Studies, [lidi.madzar@gmail.com](mailto:lidi.madzar@gmail.com)

## Резиме

Циљ овој рада јесте истраживање места и улоге малих држава у међународним економским односима. Мале државе се одликују великим степеном економске отворености, концентрацијом извоза и високом зависношћу од страничног увоза. Поред тога, оне се карактеришу и нежељеношћу отворених тржишта и дисекономијом обима. Не постоји јединствена дефиниција малих држава јер је величина релативан појам. Поред величине становништва, понекада се као критеријуми величине користе и други показатељи као што су територија или бруто домаћи производ. У овом раду су детаљно представљене ендogene и макроекономске карактеристике и проблеми малих земаља који могу бити изазовни за развој њихове привреде. Након тога су обухваћени концепти њихове економске рањивости и еластичности. Даље овај рад посвећује посебну пажњу аргументима у корист регионалне сарадње између малих држава. Последњи део рада је посвећен сличностима, али и значајним економским разликама између малих европских држава. Такође се наглашавају и предности њиховог чланства у Европској унији. Из процеса регионалних интеграција произилазе бројне економске користи за мале чланице, посебно на плану јачања економске отпорности, спољне трговине, јачања њихове привредне моћи, заједничког управљања регионалним јавним добрима, примања техничке помоћи и на геополитичком плану.

**Кључне речи:** економска рањивост, економска еластичност, дисекономија обима, мало домаће тржиште, спољни шокови, регионална сарадња, Европска унија.

## Introduction

Small countries are characterized by a high degree of economic openness, export concentration and high dependence on strategic imports such as imports of food, fuel and industrial goods. These factors are associated with their economic vulnerability, and bring the countries high exposure to the harmful effects of external shocks (international economic and financial crises, armed conflicts, environmental problems on a global scale, etc.). In addition to these, there are other characteristics of small states that occur as economic disadvantages, which do not lead to the direct economic exposure of the country to external economic forces. These include limited possibilities to use economies of scale, mainly due to the indivisibility of overhead costs related to the smaller scope of economic activities. In addition, there are limitations in the effectiveness of competition policy because of the ease with which a small market can be monopolized or

controlled by a few companies. In the case of small countries, especially island nations, there is an additional economic disadvantage that is associated with their isolation and geographical distance, exposure to natural disasters and sensitivity to climate change.

Despite these characteristics, many small countries record relatively high rates of gross domestic product (GDP) per capita. In the literature it is known as the Singapore paradox and it says that even a vulnerable small country can be very successful in economic terms (Briguglio, Cordina, Farrugia & Vella, 2008). This contradiction can be explained by the concept of economic vulnerability and economic resilience of small states.

Although they can be very heterogeneous, small countries are commonly faced with similar problems. These problems are primarily related to indivisibility of fixed costs and diseconomies of scales. In the private sector, this situation leads to higher costs and decrease in the volume of service provision. In the private sector this problem is reflected in the concentrated market structure and the lack of diversification, while in trade, this situation results in high transport costs which further rise in the case of the most remote small states. Their small size also affects the functioning of the financial sector as well as the way they solve the problems of their exposure to natural disasters. All described can be subsumed under a number of their common macroeconomic characteristics such as high trade openness, big government spending on wages, excessive government intervention, strong reliance on tax revenues from trade and frequent use of fixed exchange rate.

Market size affects productivity because large markets allow businesses to use the effects of economies of scale which is not possible in the case of small countries. In the traditional sense, markets were limited by national borders. However, in the era of globalization, international markets have replaced domestic markets, which is particularly important for the markets of small countries. Thus export can be viewed as a substitute for domestic demand in determining the size of the market of a country. The inclusion of both domestic and foreign markets in the measure of the size indicates the importance of export-oriented economies and geographic areas (such as the European Union), which consist of a number of countries - members of a certain common market (Schwab, 2015).

## **1. Definition of small states**

The World Bank defines small states as countries that either a) have a population of 1.5 million inhabitants and less, or b) that are members of the Forum of Small States (World Bank Group, 2016). This definition is common in the literature, including reports of small states of the Commonwealth Secretariat. It is also used in the framework of the International Monetary Fund, as well as in the reports

of the International Development Association. However, in practice, many countries with a population above this number can also be regarded as small and apply the same policies. In this context, it is possible to define a subgroup of *microstates* that have less than 200,000 inhabitants (International Monetary Fund, 2013). Although only arbitrary in nature, the number is used in the literature because of the need for their classification.

There is no single definition of small states because the size is a relative term. In addition to population size, sometimes other indicators are used, such as territory or gross domestic product. Population is also in high correlation with the territory, as well as with the value of GDP. Therefore, the use of population as an indicator of the size helps highlight the limited resources of small countries (Commonwealth Secretariat, 2000).

Following the same principle, the choice of a particular number of inhabitants in defining small countries is of no particular significance. In addition to the countries that have less than 1.5 million people, this group may include larger countries which share the same characteristics with small countries. No definition of small states, based on population, geographic size or GDP, is entirely satisfactory. In practice there is a continuum of states with higher number than the defined that have the same features as small countries. Therefore, this work and its findings can be applied, at least to some extent, to all such countries and geographic areas. To understand better the behavior of small states, as well as to understand the challenges and opportunities they face, it is important to define them as precisely as possible. However, as there is no general agreement on their definition, those that are commonly used in practice are usually problematic (Commonwealth Secretariat, 2000).

## 2. Characteristics of small states

As already mentioned, because of their size, small countries cannot benefit from economies of scale. On the other hand these benefits are available to most countries in their public, private and financial sector, trade, and in their *responses* to natural disasters. Although there is a significant difference between countries belonging to different regions, this fact has spawned several common macroeconomic characteristics of small countries.

It is believed that small countries have a number of endogenous characteristics that may pose special challenges for the development of their economies. They refer to their (International Monetary Fund, 2013):

- Fixed costs in the public sector - in providing public goods and services diseconomies of scale can limit institutional capacity due to the fixed costs of security, infrastructure, regulatory actions, education and management

policies. This can lead to an increase in average prices in the public sector of small states, as well as to insufficient provision of certain public goods and services;

- Fixed costs in the private sector - in smaller economies, high fixed costs of private sector activity lead to more concentrated structure of the market and reduce competition. Trade can help to overcome these obstacles, while it may be limited itself;
- High trade costs - specific fixed costs related to road infrastructure mean higher trading costs for small states which can be additionally burdened with poor infrastructure. It has been demonstrated that such effects are higher in poorer and more remote countries;
- Fixed costs and access to the financial market - small countries can have an adverse access to global capital. Numerous studies point to the natural disadvantages of small states in accessing financial markets. It is likely that the creditors will not be willing to invest in specificities of small states because they may be considered unstable countries and
- Sensitivity to natural disasters - most small countries are exposed to natural disasters (such as earthquakes and hurricanes) due to the combined effects of their location and small size. At the same time, most of them are island states that face particular challenges of climate change. In addition to the cost of human lives, natural disasters lead to significant macroeconomic imbalance. They cause destruction or depreciation of infrastructure and adversely affect the well-being, even if these effects are not always reflected in the reduction of income. These risks are most present in small poor countries. The sectoral and geographic concentration affects increase in susceptibility to natural disasters and other real shocks.

In addition to the above, small countries are reflected in a number of macro-economic characteristics (International Monetary Fund, 2013):

- Fiscal characteristics - small countries have a bigger share of public spending in total GDP and greater allocations for salaries that reflect the fixed costs in the public sector. They also tend to depend on trade charges that reflect greater openness and capacity challenges in the implementation of comprehensive tax system, as well as in the proliferation of income tax and other incentives. Caused by a lack of competition in the private sector, the high level of state intervention, including state-owned enterprises, creates a quasi-fiscal risk and contributes to the high public debt. High public debt is also partly a consequence of the difficulties that small countries face in managing natural disasters;
- Production and trade - large trade openness of small countries is partly reflected in the fixed costs of private sector activities that trade can neutral-

ize. The impossibility of simultaneous exploitation of economies of scale in many industries leads to the concentration of exports and to the orientation toward the production of several goods and services. Limited diversification of production and reduced volume of goods and services traded, as well as a smaller number of trading partners may affect the growth and vulnerability;

- The labor market - limited ability to use the expertise represents a possible factor of higher emigration rate of highly educated population. Highly concentrated management in the public and private sectors assigns individuals responsible for the management a wider range of tasks and duties and
- Monetary and financial indicators - financial sector of small countries is usually shallow, except in the case of countries with offshore financial centers. In spite of the increased presence of foreign investors, this sector is characterized by less access to finance and more concentrated banking sector. The mismatch on loans, deposits and real lending rates may prevent investment and growth, and relatively narrow and shallow financial sector can reduce the resistance, that is resilience of the country. Greater use of crawling peg and exchange rates, which are otherwise difficult to manage, can affect the fixed costs of running an independent monetary policy or its lower efficiency due to weak monetary transmission mechanism.

Moreover, small countries are heterogeneous and some of these characteristics are largely expressed in certain regions. All described characteristics of small states have major macroeconomic significance. Macroeconomic implications of weak institutional capacity are present both in developing as well as in middle-income small countries. It also highlights a lack of diversification, trade instability, instability of external demand, low competition and vulnerability to natural disasters. Weak monetary mechanisms are considered to be inhibitors of effective monetary policy in the poorest small countries. Small countries with upper-middle income are characterized by high levels of debt, reduced efficiency of fiscal policy due to high trade openness and quasi-fiscal risks associated with the cumbersome public sector.

### **3. Concept of economic resilience and vulnerability**

Development of different approaches to economic resilience has emerged from the need to better understand and substantiate policies, resources, instruments and mechanisms of prevention, mitigation, reduction and countering the negative effects of various environmental, economic and financial shocks. Economic resilience, that is, resistance is equally followed by the term economic vulnerability. Economic vulnerability stems from a large number of endogenous character-

istics of a country, permanent or temporary, in relation to which, neither direct nor predictable decisions can be made. Usually it is about material consequences of natural disasters, extreme natural phenomena and climate change, as well as the consequences of the global economic and financial crisis, the global recession and the like. Although economic vulnerability arises from the functioning of the economy, it can not be considered as a result of poor or below average performance of government (Zaman & Vasile, 2014).

Economic vulnerability mainly involves susceptibility of the observed country to the negative effects or to the damage caused by the influence of external economic forces. Although there is some controversy whether economic vulnerability presents a disadvantage for small business, the general opinion is that the characteristics of small states include a high degree of openness of the economy and a high rate of export concentration. These characteristics of small countries are generally seen in the literature as conditions that are related to the emergence of economic vulnerability as they affect their high exposure to external shocks (Briguglio, 2014). The index of economic vulnerability may be determined based on the following indicators (Zaman & Vasile, 2014): a) the economic openness (participation of foreign trade in GDP), b) concentration of export (as a consequence of a lack of diversify), and c) dependence on the strategic import.

On the other hand, economic resilience refers to the extent to which a country's economy can sustain or deny the negative effects of external shocks. As such, it is contrary to the concept of economic vulnerability. Thereby, a clear distinction should be made between economic resilience, which is developed and managed as a result of deliberately driven policies, and economic vulnerability which arises from endogenous characteristics of the economy (Briguglio, 2014). Economic resilience, therefore, relates to the ability of the economy a) to absorb the effects of external economic shocks, b) to recover quickly from them, and c) to affect their harmful effects. Guided by this definition, the author Briguglio created the elasticity index which consists of the following components (Briguglio, 2014): a) macroeconomic stability, b) market efficiency, c) social development, and d) good policy management. Later he added environmental management to these elements. These variables are heavily influenced by political measures and associated with the ability of the economy to absorb or to neutralize the adverse effects of external shocks. Many studies suggest that countries with high income show greater resistance compared to countries with medium or low income. Height of economic resilience varies depending on the size of the country. The smallest countries are also the most vulnerable compared to larger countries which may be better at dealing with external shocks.



#### 4. Weaknesses and structural problems faced by small states

In addition to the extreme economic vulnerability and a lack of resilience, small countries are also faced with common structural problems and weaknesses, such as (International Monetary Fund, 2015):

- **The performance of the growth of small countries that are still vulnerable to external shocks** - although indicators of vulnerability of small states have been recently slightly lower, they are still higher than they were before the global financial crisis;
- **Several factors that contribute to the vulnerability of small states** - the main factor refers to the generally poor quality of economic institutions. In empirical terms countries with weak institutions usually do not implement effective countercyclical macroeconomic measures to mitigate external shocks. Apart from that, debt levels are high in many small countries, while the reserves could be larger, leaving little fiscal space to mitigate the impact of external shocks. Generally speaking, government revenues and spending are unstable and often depend on economic trends in developed countries - trading partners. Finally their geographical position exposes them to the risk from natural disasters;
- **The prolonged global slowdown that will have a significant impact on small states** - small states are particularly vulnerable to the risks of slowing growth in the advanced economies. This implies the importance of this issue for the sectors of tourism, financial services and exports as well as remittances, aid and other input investment flows. Some small countries are directed towards the markets of BRICs (Brazil, Russia, India, China and South Africa) and they are very sensitive to this field and
- **The growth in small countries, which is limited by structural obstacles** - after the global financial crisis, their slight progress has been recorded. Since their progress in achieving economic diversification is also limited, there is a need for deepening structural reforms to strengthen governance and improve the business environment in order to increase their competitiveness and economic attractiveness.

#### 5. Regional solutions

Regional approaches to solving these problems can be useful when large gains are possible to obtain and when regional institutions enjoy support from their member states. In some cases, the involvement at the regional level is a comparative advantage. In the case of regional cooperation between small countries international lenders can support regional agreements and arrangements in many important areas such as fishing, tourism, labor migration, natural disaster risk



management, health, education and infrastructure (World Bank Group, 2016). Developing small and *microstates* face numerous disadvantages due to their low bargaining power and limited financial and human resources in conducting international negotiations. By signing the regional cooperation and negotiation agreement on behalf of the block, they can benefit from the growth of their bargaining power and lower costs of international negotiations. As the world has become more integrated, the number of issues that should be resolved at the regional level has also increased.

Regional blocks often occur within a geographical region because their members often have similar interests. The reason is that they produce and export similar products and conduct negotiations on similar issues with the same global forces and institutions. Members of regional integration have pooled their resources for negotiations and formulated common political views in negotiations with larger countries, trading blocks and international organizations. Although some members of the regional block can benefit from the cost-sharing of international negotiation, taking a common position on any issue from the negotiations with foreign entities causes additional costs. Process which leads to the common position may be complicated and expensive, especially if the group of countries is large and if their initial positions significantly differ (Schiff, 2010). On the other hand, greater similarities between the member states can reduce the cost of achieving consensus.

The strategy of regional cooperation between small developing countries should be based on supporting economic reforms in the areas of economic policy, public sector management and public authority. Given their great need to improve the capacity, the function of technical assistance from the international multilateral institutions has still great significance. Technical assistance should be focused on poverty reduction, widening access in rural areas, the development of health care and primary education, including informal education. This assistance should also include the transport infrastructure in order to improve access to underdeveloped areas (Commonwealth Secretariat, 2000).

Small countries, as members of certain regional integration, benefit from decreasing and abolishing barriers to foreign trade. In economic terms, they benefit from the common trade advantages, and achieve significant political gains too. In addition to the generally known economic benefits such as increasing prosperity, greater capital inflows, better allocation of resources, reduction or abolition of trade barriers, free movement of factors of production, etc., regional cooperation of small states includes the following important areas (Schiff, 2002):

- Regional public goods - if small countries dealt with regional public goods on an individual basis, without internationalization of effects to other countries in the region, it could lead to a situation in which everyone would be at

a loss due to a lack of cooperation. Therefore, regional cooperation relating to public goods such as water basins (lakes, rivers), infrastructure (roads, railways, dams), environment, waterpower and other sources of energy, fisheries, etc. can be of great benefit;

- International negotiations - another area where small countries can benefit from regional cooperation includes international negotiations and visibility on the international scene. They face serious disadvantages compared to other countries due to their low bargaining power and the high fixed costs of negotiations. On the other hand, they often do not possess the necessary human and physical capacity for unilateral conduct of bilateral and multilateral negotiations that are typical for developing countries. The formation of regional grouping with neighboring countries can help the observed country in the distribution of fixed costs of negotiations and to increase their bargaining power and
- Regional integration agreements and regional cooperation - in this context, the question is whether the regional integration agreements are beneficial and necessary for successful regional cooperation. The literature has not reached a consensus on this subject. Under certain circumstances, regional integration agreements may be useful, but not necessary. These agreements can help create an atmosphere of trust, which in turn may encourage the negotiation of regional public goods. On the other hand, these agreements can lead to tensions between member states when the distribution of benefits and losses is asymmetric and when such situation may impede or prevent the implementation of joint solutions.

Finally, it is known that regional integration and cooperation between small states can serve as an important tool in overcoming the problem of vulnerability, weak institutional capacity, high infrastructure costs and limited access to external financial resources. Therefore they insist on encouraging these processes, with special emphasis on (Commonwealth Secretariat, 2000): a) financing integration projects, that is, support to strengthening economic integration, b) support to improving negotiating capacity of small states in fulfilling their regional and global obligations and c) to support to the financial cooperation between small countries in areas such as education, health and justice.

## 6. Some characteristics of the small European countries

In the European Union, the size of the country is determined on the basis of economic and financial power (GDP), political power (the number of votes in the Council of Ministers and the number of members of the European Parliament), population and territory. Size is a relative term. Even if one could draw a *rough*

line between small and large states, which would be based on the indicators above and below the average of EU-28, grouping of countries would vary depending on the applicable criteria.

Distribution of votes in the system of qualified majority in the Council of Ministers of the European Union is a good starting point for determining whether a certain country is small or large (Panke, 2008). It measures the political and economic power, which represents an important capacity for the creation of political and economic processes of the EU. Compared to the unanimous system, the rule of qualified majority is unfavorable for small states. It is more difficult for countries with fewer votes to form a winning coalition in the Council of Ministers of the EU. Besides, the European Commission often focuses on large countries when designing strategic documents, knowing that they have greater bargaining power in the Council of the EU.

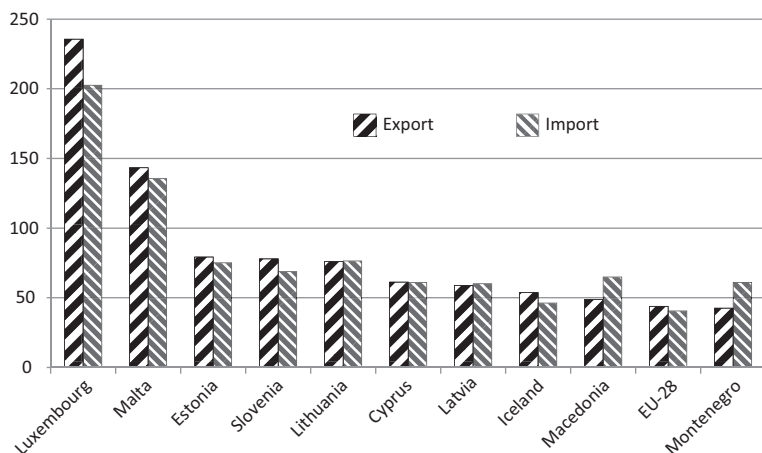
As already mentioned, small states face particular disadvantages that are associated with their small domestic market, limited natural resources and restrictions on diversification of economy. Because of the aforementioned characteristics they tend to depend greatly on international trade and exposure to external shocks. If we could define, for the purposes of this analysis, the small EU members as countries with a population of 3 million or less, it could be said that, despite their limitations, seven small member states of the EU that are included in this analysis (Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia) have relatively high gross GDP per capita. It can be concluded that they, together with the larger member states such as Germany, Italy, Great Britain and Spain, have integrated well into the Union. In addition to these EU member states, this paper also discusses Macedonia and Montenegro as candidates, as well as the economic indicators of Iceland which withdrew its candidacy and thus gave up on joining the EU in 2013.

In addition to the high relative costs and problems of indivisibility of general expenses, another problem faced by small states of the EU refers to the power of their voice in organizations dominated by much larger countries. There is a possibility that the interests of small states can be neglected due to the limited ability to influence decision-making processes. Although this situation is a disadvantage for them, it should be noted that the power of their vote is much greater in the European Union than it would be if they were not members of the EU. There is an overview below of some of their common economic characteristics and differences.

**The high degree of openness to trade** - the fact that small countries have a small domestic market means that they can not be *relied upon* due to the small volume of production mainly of similar goods and services. In addition, they have scarce natural resources and they are usually heavily dependent on imports

of food, fuel and industrial goods. Such dependence on trade makes them extremely vulnerable and sensitive to external economic shocks.

Ten small European countries analysed in this work, are characterized by trade openness, headed by Luxembourg, Malta and Estonia, which are in the group of most open economies. With the exception of Montenegro, the degree of openness of all observed countries is higher than the average of EU-28. Therefore, it can be concluded that their economic performance is largely caused by the influence of external factors.

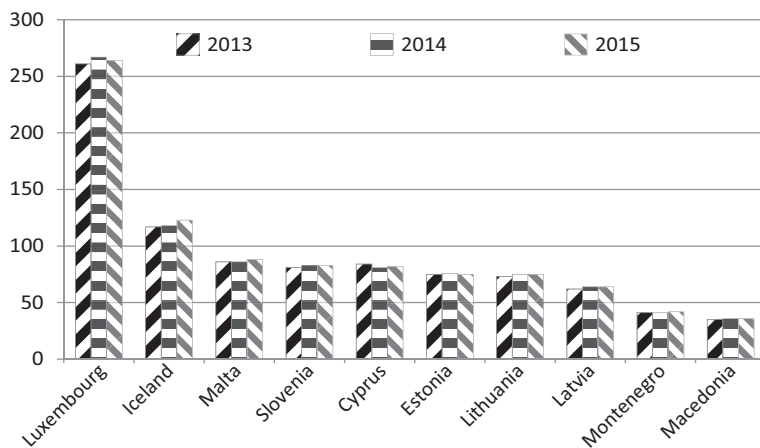


**Chart 1** Exports and imports of goods and services expressed in % of GDP

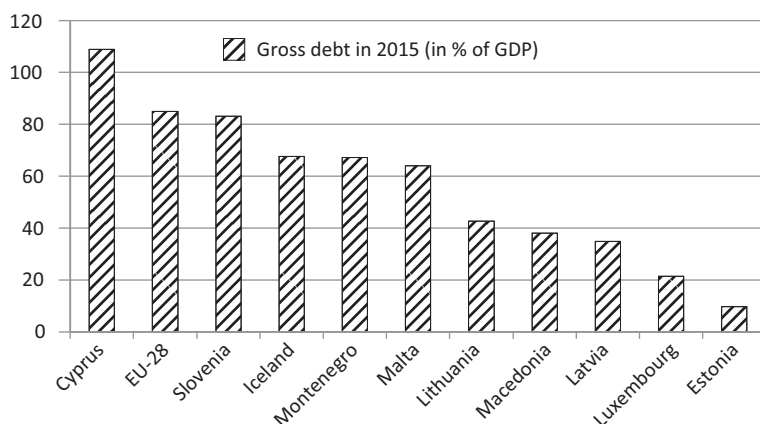
Source: Eurostat. International trade. Retrieved on 22.1.2017 from <http://ec.europa.eu/eurostat/web/economic-globalisation-indicators/indicators/trade> (Author's analysis)

**Gross domestic product per capita and GDP growth** - GDP per capita of ten small states is also noticeably different as shown by the following graph. Luxembourg is by far the biggest revenue generator among the surveyed countries and in the EU, followed by Iceland and Malta. On the other hand, Lithuania and Latvia as the EU members and Montenegro and Macedonia as candidates recorded the lowest GDP per capita.

**The gross debt of the country** - while Estonia and Luxembourg recorded the lowest share of gross debt to its GDP in 2015, Latvia, Macedonia, Lithuania, Malta and Montenegro were moderately indebted. It should be noted that in all these countries there was an increase in the debt ratio following the global recession. At the same time, Cyprus, Slovenia and Iceland faced the risk of insolvency.

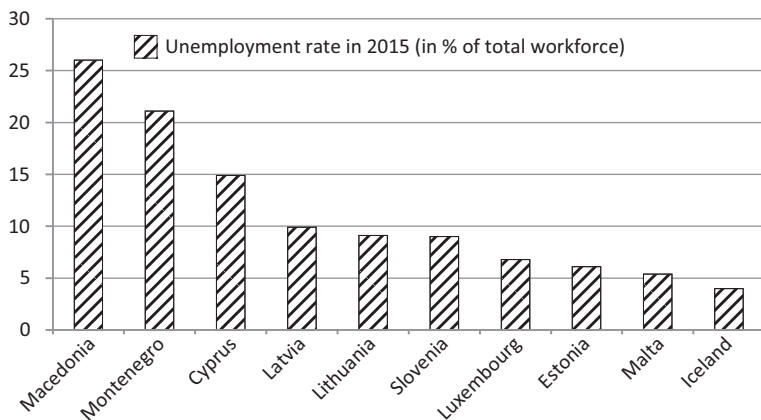


**Chart 2** GDP per capita in the period 2013-2015 (in euro). Source: Eurostat. Volume indices per capita, 2013-2015 (EU-28=100). Retrieved on 22.1.2017 from [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Volume\\_indices\\_per\\_capita,\\_2013-2015\\_\(EU-28%3D100\)\\_Dec.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Volume_indices_per_capita,_2013-2015_(EU-28%3D100)_Dec.png) (Author's analysis)



**Chart 3** Total gross debt in 2015 (in % of GDP). Source: *Eurostat*. General government gross debt (% of GDP). Retrieved on 22.1.2017 from <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde410&plugin=1> and International Monetary Fund. IMF Outlook database. Retrieved on 22.1.2017 from [http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=41&pr.y=7&sy=2014&-ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=GGXWDG\\_NGDP&grp=0&a=](http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=41&pr.y=7&sy=2014&-ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=GGXWDG_NGDP&grp=0&a=) (Author's analysis)

**The unemployment rate** - the unemployment rate in these countries is also significantly different. Macedonia has the highest unemployment rate of 26%. On the other hand, there is Estonia with the rate of 6.1%. Compared to previous years, in most of these countries there was a growth of this indicator in the period from 2010 to 2014. After the global financial crisis, the Baltic countries and Cyprus registered the highest unemployment rate among small states of the European Union.

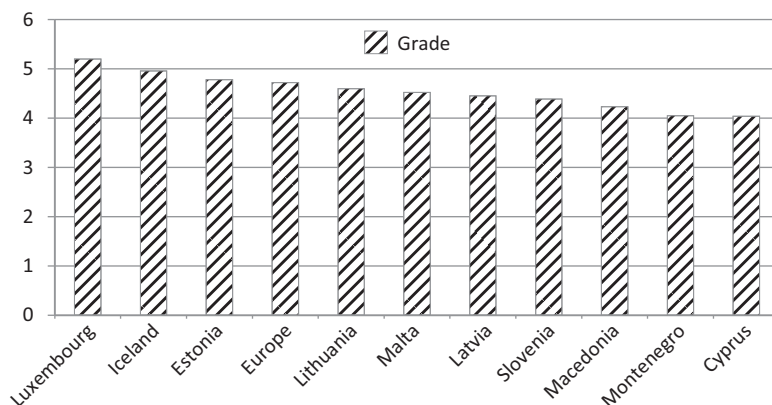


**Chart 4** Unemployment rate in 2015 (in % of total workforce).

Source: International Monetary Fund. IMF Outlook database. Retrieved on 22.1.2017 from <http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=76&pr.y=10&sy=2014&ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=LUR&grp=0&a=> (Author's analysis)

**Problematic business factors** - the latest Global Competitiveness Report is based on the responses of surveyed executives and business people, and aims to identify the most problematic business factors in the countries studied. The following figure indicates the perceived problematic factors that are reflected in the average grade, that is, in ranking these small ten countries.

Access to business finance is considered to be the most problematic factor in Cyprus, Montenegro and Macedonia, while the inefficient state bureaucracy is seen as the biggest obstacle in doing business in Lithuania and Malta. In the case of Estonia and Luxembourg the most problematic business factor is inadequately educated workforce. Restrictive labor regulations are seen as the most problematic factors in Slovenia, whereas foreign exchange regulations are limiting business factors in Iceland.



**Chart 5** Ranking countries according to the Global Competitiveness Index 2016-2017  
 Source: Schwab, K. (ed.). (2016). *The Global Competitiveness Report 2016-2017*. Geneva: World Economic Forum, p. 44-45.

## 7. Benefits of the European Union membership

The main advantage of the membership of the surveyed countries in the European Union is the free movement of goods, services, labor and capital. Small countries heavily depend on exports because of their small domestic market and therefore, they favor a smaller volume of barriers to free trade. Such opportunities enable them to benefit from economies of scale. In addition, intense competition under such circumstances may also improve the allocation of their resources.

Another benefit of the EU membership is reflected in the European Commission's insistence on research and development which motivated and enabled these countries to improve their production capacities. In the case of small countries where human resources are the main factor of production, the improvement of labor productivity as a result of innovation is of extreme importance.

Small countries are also able to use regional and other EU funds which, among other things, enabled the successful adoption and implementation of regulations and the EU directives. With the exception of Luxembourg, nine out of ten surveyed small states received more funds than they contributed to the common EU budget. The Baltic countries were the biggest net recipients of the EU funds (Briguglio, 2016). In spite of this, their largest gains from the EU membership come from the geo-political situation in the region where peace, political stability and freedom have the largest importance considering their recent historical circumstances (being a part of the USSR). Luxembourg, as a large net lender in the EU budget, has the biggest benefit from the membership in the fact that a significant number of European Union institutions operate on its territory. On



the other hand, Montenegro and Macedonia, as candidates, received significant funding from the EU pre-accession funds.

## Conclusion

There are similarities and differences among many small European countries. Their main similarity lies in the fact that they are all vulnerable. Nevertheless, some of them are extremely successful in terms of the level of GDP per capita and the resulting economic growth, which points to the fact that their respective economic policy allows them to cope with their vulnerability. However, the analysis clearly implies that the observed states are a homogenous group. They differ in many aspects, especially in the degree of development.

Objective and subjective benefits for these countries derive from their membership in the EU, while in the case of the non-EU members they significantly differ. All these countries have benefited from free access to the large market. Many of them also use transfers of funds from the European Union. However, regarding the Baltic countries geopolitical reasons are considered to be the greatest benefits of the EU membership. On the other hand, although Luxembourg is a large net lender, the country has benefited greatly from the fact that a significant number of the EU institutions operate on its territory. Malta has made big profits from the transfers of funds, which enabled a significant improvement and development of infrastructure. The observed group of countries is heterogeneous in many aspects, but what mostly connects them is the small size of the domestic market, high exposure to external economic conditions, and weak political and bargaining power in the EU institutions.

## Literature

- Briguglio, L., Cordina, G., Farrugia, N. & Vella, S. (2008). Economic Vulnerability and Resilience: Concept and Measurements. *Research Paper*, 55. Retrieved on 3. 1. 2017 from [https://www.researchgate.net/publication/46527233\\_Economic\\_Vulnerability\\_and\\_Resilience\\_Concepts\\_and\\_Measurements](https://www.researchgate.net/publication/46527233_Economic_Vulnerability_and_Resilience_Concepts_and_Measurements)
- Briguglio, L. (2014). A Vulnerability and Resilience Framework for Small States. In *Building the Resilience of Small States – A Revised Framework* (p. 10-76). London: The Commonwealth.
- Briguglio, L. (2016). Introduction: Small states and the European Union. In *Small States and the European Union – Economic Perspectives* (p. 1-27). London: Routledge.
- Commonwealth Secretariat. (2000). *Small States: Meeting Challenges in the Global Economy*. Washington, D.C.: Commonwealth Secretariat and World Bank Joint Task Force on Small States.

- Eurostat. General government gross debt (% of GDP). Retrieved on 22.1.2017 from <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde410&plugin=1>
- Eurostat. International trade. Retrieved on 22.1.2017 from <http://ec.europa.eu/eurostat/web/economic-globalisation-indicators/indicators/trade>
- Eurostat. Volume indices per capita, 2013-2015 (EU-28=100). Retrieved on 22.1.2017 from [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Volume\\_indices\\_per\\_capita\\_2013-2015\\_\(EU-28%3D100\)\\_Dec.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Volume_indices_per_capita_2013-2015_(EU-28%3D100)_Dec.png)
- International Monetary Fund. (2015). *Macroeconomic Developments and Selected Issues in Small Developing States*. Washington, D.C.: IMF.
- International Monetary Fund. IMF Outlook database. Retrieved on 22.1.2017 from [http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=41&pr.y=7&sy=2014&ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=GGXWDG\\_NGDP&grp=0&a=](http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=41&pr.y=7&sy=2014&ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=GGXWDG_NGDP&grp=0&a=)
- International Monetary Fund. IMF Outlook database. Retrieved on 22.1.2017 from <http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/weorept.aspx?pr.x=76&pr.y=10&sy=2014&ey=2021&scsm=1&ssd=1&sort=country&ds=.&br=1&c=946%2C137%2C962%2C181%2C943%2C423%2C939%2C961%2C176%2C941&s=LUR&grp=0&a=>
- Panke, D. (2008). The Influence of Small States in the EU: Structural Disadvantages and Counterstrategies. *Dublin European Institute Working Paper*, 08-3. Retrieved on 25.12.2016 from [http://www.ucd.ie/t4cms/WP\\_08-3\\_Diana\\_Panke.pdf](http://www.ucd.ie/t4cms/WP_08-3_Diana_Panke.pdf)
- Schiff, M. (2002). Regional Integration and Development in Small States. *Policy Research Working Paper*, 2797. Retrieved on 20.1.2017 from <https://pdfs.semanticscholar.org/b4ba/b9899d2d7c53a43885a365ec7a30fda9ae47.pdf>
- Schiff, M. (2010). Small State Regional Cooperation, South-South and South-North Migration, and International Trade. *Discussion Paper Series*, 4938. Retrieved on 20.1.2017 from <https://pdfs.semanticscholar.org/f0d3/8ed07b57627f45e2bf602d7cd53ad9b08c5e.pdf>
- Schwab, K. (ed.). (2015). *The Global Competitiveness Report 2015-2016*. Geneva: World Economic Forum.
- Schwab, K. (ed.). (2016). *The Global Competitiveness Report 2016-2017*. Geneva: World Economic Forum.
- World Bank Group. (2016). *World Bank Group Engagement with Small States: Taking Stock*. Washington, D.C.: World Bank Group.
- Zaman, G. and Vasile, V. (2014). Conceptual framework of economic resilience and vulnerability at national and regional levels. *Romanian Journal of Economics*, (2(48)), 5-18.

